Benefits, and drawbacks, of supplemental executive retirement plans

Q: I was recently promoted and have been given the opportunity to participate in a Supplemental Executive Retirement Plan (SERP). What are the pros? Are there any cons?

A: Congratulations, these nonqualified retirement plans are financial incentives for key employees/executives. They are in addition to a 401(k) and other typical retirement plans.

Non-qualified plans are a type of tax-deferred, employer-sponsored retirement plan that do not have to comply with the Employee Retirement Income Security Act (ERISA) guidelines. SERP plans aren't regulated and don't require IRS approval. There are minimal reporting obligations. Selectively offered, they are permitted to discriminate.

The company controls the plan and there is a vesting schedule used to retain and reward. The company and the executive enter into a formal conditional agreement that promises a certain amount of supplemental retirement income.
The plan can be funded by employee deferrals, matching company contributions, profit sharing or any combination.

Nonqualified deferred compensation is generally treated as wages (for FICA purposes) when services are performed. At that time, employers generally withhold FICA taxes. These deferred benefits accrue without any federal income tax consequences to the executive. Upon retirement, the employee receives the income, taxable as ordinary income, and the company deducts it as an expense.

There are no required minimum distributions at age 70.5 and no 10% early withdrawal penalty before age 59.5. Some plans allow the executive to design distributions as a lump sum or a pay out in varying amounts over a period of time. This is a golden opportunity to do some serious tax planning.

The difference between qualified and nonqualified plans is primarily the tax treatment. Contributions to a non-qualified plan are not deductible to the employer until the employee takes a withdrawal and is taxed on the income. Employer contributions to qualified plans (like 401(k)'s) may be deducted immediately.

The risks of nonqualified plans are related to the financial health of the company. Nonqualified plans are largely controlled by the plan design and the informal funding decisions are made by the employer. Since these nonqualified plans are only available to highly compensated employees, they are expected to have done their due diligence on the fiscal health of their company.

The funds are not protected from creditor claims against the company because the plans are nonqualified. The participating executive could become a general creditor subject to the same guidelines as the other general creditors of the company. Read that sentence again. You want to carefully consider the credit risk of participating in a SERP of a company that isn't financially sound.

Often participants are unaware that assets within a nonqualified plan (set aside for the participant) are subject to creditors of their employer. If the company defaults, there is no guarantee that the deferred compensation would ever be paid to the participant. This differs from qualified plans where assets are protected from creditors.

In 2003, the world's largest mapmaker filed for bankruptcy and sold all of their assets. Under the purchase agreement the new company was not required to honor the SERP.

The pros are the free money and the ability to defer income during high wage earning years. The cons are the potential loss of your deferrals and the shock of having your financial plan derailed.

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